

in the hands of the partnership before the distribution and the \$10 combined basis of the distributed property in the hands of A under section 732 after the distribution). Under section 731(c)(5), no adjustment is made to partnership property under section 734 as a result of any gain recognized by A by reason of section 731(c) or as a result of any step-up in basis in the distributed marketable securities in the hands of A by reason of section 731(c).

Example 7. Coordination with section 737. (i) A and B form partnership AB. A contributes Property A, nondepreciable real property with a fair market value of \$200 and an adjusted basis of \$100 in exchange for a 25 percent interest in partnership capital and profits. AB owns marketable Security X.

(ii) Within five years of the contribution of Property A, AB subsequently distributes Security X, with a fair market value of \$120 and an adjusted tax basis of \$100, to A in a current distribution that is subject to section 737. As part of the same distribution, AB distributes Property Y to A with a fair market value of \$20 and an adjusted tax basis of \$0. At the time of distribution, there has been no change in the fair market value of Property A or the adjusted tax basis in A's interest in the partnership.

(iii) If AB had sold Security X for fair market value immediately before the distribution to A, the partnership would have recognized \$20 of gain. A's distributive share of this gain would have been \$5 (25 percent of \$20 gain). Because AB has no other marketable securities, A's distributive share of gain in partnership securities after the distribution would have been \$0. As a result, the distribution resulted in a decrease of \$5 in A's share of the net gain in AB's securities (\$5 net gain before distribution minus \$0 net gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$5. The distribution of Security X is therefore treated as a distribution of \$115 of money to A (\$120 fair market value of Security X minus \$5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money (\$5) is treated as other property for purposes of section 737.

(iv) A recognizes total gain of \$40 on the distribution. A recognizes \$15 of gain under section 731(a)(1) on the distribution of the portion of Security X treated as money (\$115 distribution of money less \$100 adjusted tax basis in A's partnership interest). A recognizes \$25 of gain under section 737 on the distribution of Property Y and the portion of Security X that is not treated as money. A's section 737 gain is equal to the lesser of (i) A's precontribution gain (\$100) or (ii) the excess of the fair market value of property received (\$20 fair market value of Property Y plus \$5 portion of Security X not treated as

money) over the adjusted basis in A's interest in the partnership immediately before the distribution (\$100) reduced (but not below zero) by the amount of money received in the distribution (\$115).

(v) A's adjusted tax basis in Security X is \$115 (\$100 basis of Security X determined under section 732(a) plus \$15 of gain recognized by reason of section 731(c)). A's adjusted tax basis in Property Y is \$0 under section 732(a). The basis in A's interest in the partnership is \$25 (\$100 basis before distribution minus \$100 basis allocated to Security X under section 732(a) plus \$25 gain recognized under section 737).

(k) *Effective date.* This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

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§ 1.732-1 Basis of distributed property other than money.

(a) *Distributions other than in liquidation of a partner's interest.* The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Partner A, with an adjusted basis of \$15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of \$10,000 to the partnership immediately before distribution, and \$2,000 cash. The basis of the property in A's hands will be \$10,000. Under sections 733 and 705, the basis of A's partnership interest will be reduced by the distribution to \$3,000 (\$15,000 less \$2,000 cash, less \$10,000, the basis of the distributed property to A).

Example 2. Partner R has an adjusted basis of \$10,000 for his partnership interest. He receives a current distribution of \$4,000 cash and property with an adjusted basis to the partnership of \$8,000. The basis of the distributed property to partner R is limited to \$6,000 (\$10,000, the adjusted basis of his interest, reduced by \$4,000, the cash distributed).

(b) *Distribution in liquidation.* Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

Example. Partner B, with a partnership interest having an adjusted basis to him of \$12,000, retires from the partnership and receives cash of \$2,000, and real property with an adjusted basis to the partnership of \$6,000 and a fair market value of \$14,000. The basis of the real property to B is \$10,000 (B's basis for his partnership interest, \$12,000, reduced by \$2,000, the cash distributed).

(c) *Allocation of basis among properties distributed to a partner.* (1) Under section 732 (a)(2) or (b), the basis to be allocated to properties distributed to a partner shall be allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) included in the distribution. However, such receivables or inventory items may not take a higher basis in the hands of the partner than their common adjusted basis to the partnership immediately before the distribution, unless such distribution is treated as a sale or exchange under section 751(b), or unless the distributee partner has a special basis adjustment for the distributed property under section 732(d) or 743(b). Any basis not allocated to unrealized receivable or inventory items shall be allocated to any other properties distributed to the partner in the same transaction, in proportion to the bases of such other properties in the hands of the partnership before distribution. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A, whose partnership interest in partnership ABC has an adjusted basis of \$15,000, receives as a distribution in liquidation of his entire interest inventory items having a basis to the partnership of \$6,000. In addition, he receives cash of \$5,000, and two parcels of real property with adjusted bases to the partnership of \$6,000 and \$2,000, respectively. Basis in the amount of \$10,000 (\$15,000 basis, less \$5,000 cash received) is allocated \$6,000 to inventory items, and

\$3,000 ($6,000/8,000 \times \$4,000$) and \$1,000 ($2,000/8,000 \times \$4,000$), respectively, to the two parcels of real property.

(2) If the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to a partner is greater than the partner's adjusted basis of his interest (reduced by the amount of money distributed to him in the same transaction), the amount of the basis to be allocated to such unrealized receivables and inventory items shall be allocated in proportion to the adjusted bases of such properties in the hands of the partnership. If the basis of the partner's interest to be allocated upon a distribution in liquidation of his entire interest is in excess of the adjusted basis to the partnership of the unrealized receivables and inventory items distributed, and if there is no other property distributed to which such excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of his partnership interest. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Partner C, whose interest in partnership ABC has an adjusted basis to him of \$9,000, receives as a distribution in liquidation cash of \$6,000, inventory items having an adjusted basis to the partnership of \$6,000, and real property having a basis to the partnership of \$4,000. The cash payment reduces C's basis to \$3,000, which is allocated entirely to inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

Example 2. Partner B, whose interest in partnership ABC has an adjusted basis to him of \$9,000, receives as a distribution in liquidation cash of \$1,000 and inventory items having a basis to the partnership of \$6,000. The cash payment reduces B's basis to \$8,000, which can be allocated only to the extent of \$6,000 to the inventory items. The remaining \$2,000 basis, not allocable to distributed property, constitutes a capital loss in that amount to partner B under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(d) *Special partnership basis to transferee under section 732(d).* (1)(i) A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743(b) and paragraph (b) of § 1.743-1 and § 1.732-2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect.

(iv) If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

(v) If property is distributed to a transferee partner who elects under section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed of by the part-

nership. (For shift of transferee's special basis adjustment to like property, see paragraph (b)(2)(ii) of § 1.743-1.)

(vi) The provisions of this subparagraph may be illustrated by the following example:

Example. The basis to transferee partner K of his one-fourth interest in partnership WJKS is \$17,000. At the time he acquired such interest by purchase, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of \$14,000 and a value of \$16,000. K's purchase price reflected \$500 of this difference. Thus, \$4,000 of the \$17,000 paid by K for his one-fourth interest was attributable to his share of partnership inventory with a basis of \$3,500. Within 2 years after acquiring his interest, K retired from the partnership and received in liquidation of his entire interest cash of \$1,500, inventory with a basis to the partnership of \$3,500, property X (a capital asset), with an adjusted basis to the partnership of \$2,000, and property Y (a depreciable asset), with an adjusted basis to the partnership of \$4,000. The value of the inventory received by K was one-fourth of the value of all partnership inventory and was his share of such property. It is immaterial whether the inventory K received was on hand when K acquired his interest. In accordance with K's election under section 732(d), the amount of his share of partnership basis which is attributable to partnership inventory is increased by \$500 (one-fourth of the \$2,000 difference between the value of such property, \$16,000, and its \$14,000 basis to the partnership at the time K acquired his interest). This adjustment under section 732(d) applies only for purposes of distributions to partner K, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by K in the liquidating distribution is \$15,500 (\$17,000, K's basis for his interest, reduced by the amount of cash received, \$1,500). This amount is allocated as follows: The basis of the inventory items received is \$4,000, consisting of the \$3,500 common partnership basis for such items, plus the special basis adjustment of \$500 which K would have had under section 743(b). The remaining basis of \$11,500 (\$15,500 minus \$4,000) is to be allocated to the remaining property distributed to K in proportion to their adjusted bases to the partnership. Since the adjusted basis to the partnership of property X is \$2,000, and that of property Y is \$4,000, the \$11,500 is allocated \$3,833 ($2,000/6,000 \times \$11,500$) to X, and \$7,667 ($4,000/6,000 \times \$11,500$) to Y.

(2) A transferee partner who wishes to elect under section 732(d) shall make the election with his tax return:

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732(d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732(d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest:

(i) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(ii) An allocation of basis under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) A special basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

The application of the rule presented in this subparagraph may be illustrated by the following examples:

Example 1. Partnership ABC owns three parcels of land, each of which has an adjusted basis to the partnership of \$5,000 and is worth \$55,000, and depreciable property with an adjusted basis and value of \$150,000.

D purchases A's partnership interest for \$105,000 when the election under section 754 is not in effect. At the time of D's purchase, the fair market value of all partnership property (other than money) is \$315,000, which exceeds 110 percent of \$165,000, its adjusted basis to the partnership. Four years later, the partnership is dissolved. D receives one of the three parcels of land which has a basis to the partnership of \$5,000, and one-third of the depreciable property with an adjusted basis to the partnership at that time of \$45,000, one-third of \$135,000 (\$150,000 basis, minus \$15,000 depreciation computed on the partnership basis. See subparagraph (1)(iv) of this paragraph.) If D's adjusted basis for his interest at the time of the distribution was \$100,000 and was allocated under section 732(c) to the property received by him in proportion to their respective bases to the partnership, the basis to him for the distributed land would be \$10,000 ($5,000/50,000 \times \$100,000$) and the basis of the depreciable property would be \$90,000 ($45,000/50,000 \times \$100,000$). In effect, D would be attributing to the basis of the depreciable property a portion of the cost of his partnership interest properly attributable to appreciation in nondepreciable property. The application of section 743(b) to the transfer of the interest would have resulted in a different basis to D for the property actually distributed. Therefore, the special basis adjustment under section 732(d) must be made so that D must increase the basis of the land by a special basis adjustment of \$50,000 (\$55,000 fair market value less \$5,000 partnership basis), making the basis of his interest therein \$55,000 ($55,000/100,000 \times \$100,000$). D's basis for the depreciable property will then be \$45,000 ($45,000/100,000 \times \$100,000$).

Example 2. Assume the same facts as in example 1 of this subparagraph, except that the partnership does not dissolve but distributes one parcel of land to each of the partners in a current distribution. Since the conditions of this subparagraph have been met, D's basis for the distributed land is the adjusted basis such land would have if the adjustment provided in section 743(b) were in effect with respect to the partnership property. Therefore, D's basis for the land is \$55,000 (\$5,000 basis of the land to the partnership, plus \$50,000 special basis adjustment under section 732(d)). D's basis for his partnership interest is reduced by \$55,000, his basis for the property distributed.

(e) **Exception.** When a partnership distributes unrealized receivables (as defined in section 751(c)) or substantially appreciated inventory items (as defined in section 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership

property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of section 751(b). In such case, section 732 (including subsection(d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See section 751(b) and paragraph (b) of § 1.751-1. However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751(b). Consequently, the basis of such property shall be its cost to the partner.

§ 1.732-2 Special partnership basis of distributed property.

(a) *Adjustments under section 734(b).* In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) *Adjustments under section 743(b).* In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d) thereof), the adjusted partnership bases of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

Example. Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of partnership property in accordance with section 743(b). One of the assets of the partnership at the time D acquired his interest was property X, which is later distributed to D in a current distribution. Property X has an adjusted basis to the partnership of \$1,000 and with respect to D it has a special basis adjustment of \$500. Therefore, for purposes of section 732(a)(1), the adjusted basis of such property to the partnership with respect to D immediately before its distribution is \$1,500. However, if property X is distributed to partner A, a nontransferee partner, its adjusted basis to the partnership for purposes of section 732(a)(1) is only \$1,000. In such case, D's \$500 special basis adjustment may shift over to other property. See paragraph (b)(2)(ii) of § 1.743-1.

(c) *Adjustments to basis of distributed inventory and unrealized receivables.* Under section 732, the basis to be allocated to distributed properties shall be allocated first to any unrealized receivables and inventory items. If the distributee partner is a transferee of a partnership interest and has a special basis adjustment for unrealized receivables or inventory items under either section 743(b) or section 732(d), then the partnership adjusted basis immediately prior to distribution of any unrealized receivables or inventory items distributed to such partner shall be determined as follows: If the distributee partner receives his entire share of the fair market value of the inventory items or unrealized receivables of the partnership, the adjusted basis of such distributed property to the partnership, for the purposes of section 732, shall take into account the entire amount of any special basis adjustment which the distributee partner may have for such assets. If the distributee partner receives less than his entire share of the fair market value of partnership inventory items or unrealized receivables, then, for purposes of section 732, the adjusted basis of such distributed property to the partnership shall take into account the same proportion of the distributee's special basis adjustment for unrealized receivables or inventory items as the value of such items distributed to him bears to his entire share of the total value of all